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ORIGINAL

EXCEPTION

Mountain Pass Utility Company
Docket No. SW-03841A-01-0166

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Application for Authorization of Financing

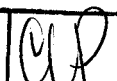
Exceptions to Staff Report

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Mountain Pass Utility Company ("MPUC") filed an application on February 26, 2001 for authority to issue up to \$7,200,000 in equity to fund the Company's initial sewer infrastructure. The Company is not currently serving any customers. However, it is incurring costs for permitting, engineering and other infrastructure requirements in preparation for providing sewer service to a proposed 6,200 unit development, and needs financing approved at this time in order to meet its obligations as they come due.

Staff recommended the following:

- That MPUC file a copy of its ADEQ Approval to Construct within 30 days of an order;
- That MPUC be authorized to issue up to \$5,700,000 in equity; and
- That MPUC finance the initial \$1,500,000 cost of the sewer collection system with Advances in Aid of Construction ("AIAC's") instead of with equity as proposed by the Company.

MPUC asserts the following EXCEPTIONS to these recommendations by Staff:

1. Staff's recommendation that MPUC file a copy of its ADEQ Approval to Construct within 30 days of an order should not be adopted because the Company already has an order in Decision No. 62757 (Docket No. SW-03841A-00-0124), as extended, to submit ADEQ's Approval to Construct by July 25, 2003, which allows the Company the time it needs to obtain the necessary Approval to Construct from ADEQ. The Company cannot comply with the 30 days recommended by Staff in this proceeding.
2. Staff's recommendation that only up to \$5,700,000 in equity be authorized and that the remaining \$1,500,000 cost of the initial collection system be financed with AIAC's should not be adopted. The Company's request for authorization to issue up to \$7,200,000 in equity should be approved because:

SHAREHOLDERS SHOULD PROVIDE THE FUNDS FOR THE INITIAL FACILITIES THAT ARE REQUIRED TO PROVIDE SEWER SERVICE TO ITS CUSTOMERS.

The initial facilities should be constructed with equity advanced by the shareholders, and the replacement facilities should be constructed with the funds collected for depreciation expense.

THERE IS NO PROVISION IN RATES FOR THE FUNDS REQUIRED TO REFUND THE OBLIGATIONS UNDER THE AIAC's.

Rates are established based on the cost of providing service plus a reasonable rate of return on the investment in plant. However, since AIAC's are refunded based on a percentage of revenues generated, they are not recoverable through cost of service nor through the return on the investment in plant (because there is no investment in plant financed through AIAC's until the refunds are made). As a result, there is no provision in rates from which funds can be generated in order to meet the refund obligations.

THE USE OF AIAC'S RESULTS IN INCREASED RATES TO THE RATEPAYERS.

Since there is no provision in rates for the funds necessary to repay the obligations under AIAC's, the utility must increase its rates in order to generate the funds that are needed to refund the obligations. Pima Utility Company, a water and sewer utility in Arizona that is affiliated with MPUC through overlapping principals and management, provides an illustration. In its incipient years of operation, Pima utilized AIAC's to finance the acquisition of its initial water and sewer lines. However, it took three rate increases in a five-year period for Pima to generate the cash flow that enabled it to meet its annual AIAC refund obligations. In a most revealing statement in Decision No. 58743, which granted Pima its third

rate increase in five years, Page 14 of the Order stated that "the Company presented evidence that its cash flow position had worsened and AIAC refund obligations have not been met despite the previous inclusion of these amounts in the last rate case". * It is clear that obligations under the AIAC's cannot be met without increasing rates. Significantly, if MPUC's proposal to finance the cost of the initial sewer collection system with equity is adopted, the Company's shareholders will bear the cost of the initial facilities instead of shifting that burden to the ratepayers which will occur under the proposal by Staff to use AIAC's:

* The three increases in rates are in the following dockets:

1. Decision No. 56552 dated July 13, 1989, Docket No. U-2199-88-210;
2. Decision No. 57645 dated November 27, 1991, Docket No. U-2199-90-221; and
3. Decision No. 58743 dated August 11, 1994, Docket No. U-2199-93-222.

THE USE OF AIAC's WILL EVENTUALLY REQUIRE AN ORDER FROM THE COMMISSION AUTHORIZING THE ISSUANCE OF EQUITY TO REPAY THE OBLIGATIONS.

In addition to increasing its rates to meet its annual AIAC refund obligations, Pima Utility Company also had to obtain authorization from the Commission to issue equity to refund the AIAC obligations that it had accumulated and were in arrears. Decision No. 58743 not only authorized an increase in rates, but also approved \$2,356,100 in equity, most of which was used to repay the AIAC obligations that were in arrears and to finance the acquisition of initial water and sewer lines in a new area of the development. The Staff Report in that proceeding, which supported the issuance of equity instead of AIAC's, said that "growing and expanding companies are heavy consumers of cash, so (the utility) needs to preserve its internally generated cash to finance expanding operations rather than having to use it to pay AIAC refunds". Another benefit to the Company's proposal is that the enormous costs of applying for and litigating the additional rate and financing applications which are passed on to the ratepayers can be avoided if the Company's proposal to finance the acquisition of the initial sewer lines with the equity is adopted.

THE COMMISSION HAS PREVIOUSLY AUTHORIZED THE USE OF EQUITY TO FINANCE THE ACQUISITION OF WATER AND SEWER LINES.

The Commission has authorized the use of equity to finance the acquisition of water and sewer lines in all of the requests for such financing that have been filed by affiliates of MPUC, which include:

- Pima Utility Company, Decision No. 57645 dated November 27, 1991 (\$2,356,100 total equity financing approved.)
- Pima Utility Company, Decision No. 59130 dated June 27, 1995 (\$5,338,468 total equity financing approved.)
- SaddleBrooke Utility Company, Decision No. 59134 dated June 27, 1995 (\$2,444,198 total equity financing approved.)
- Lago Del Oro Water Company, Decision No. 60227 dated June 5, 1997 (\$2,894,529 total equity financing approved.)
- Lago Del Oro Water Company, Decision No. 62845 dated August 24, 2000 (\$1,500,000 total equity financing approved.)

AIAC's ARE NOT A REQUIRED METHOD OF FINANCING THE ACQUISITION OF WATER AND SEWER LINES

AIAC's are not required to finance the acquisition of water and sewer lines, but instead are an option that can be used by utilities when certain circumstances exist. Support that AIAC's are not required is

provided in Commission Decision No. 61994 dated October 8, 1999 which granted a sewer CC&N to Picacho Sewer Company, which is affiliated with MPUC through overlapping principals and management. Conclusions of Law No. 7 on Page 7 of the Order states that "A.A.C. R14-2-606 does not mandate the use of AIAC's to finance line extensions."

THE CONDITIONS WHERE AIAC's CAN BE UTILIZED DO NOT EXIST IN THE CASE OF MPUC.

AIAC's can be utilized when facilities are required exclusively for a new service and when the cost of the facilities are disproportionate to other customers (see A.A.C. R14-2-406, and Paul M. Hoffenburg, et al vs. Arizona Corporation Commission, 1992). MPUC will be providing sewer service to the age-restricted, master-planned community of SaddleBrooke Ranch where residential lots are situated and sized uniformly and are constructed sequentially within the development. The sewer lines are neither exclusive to one service nor are the costs disproportionate to any customer, which obviates the need for AIAC's.

FOR THE REASONS CITED IN THESE EXCEPTIONS, THE COMPANY PROPOSES THE FOLLOWING MODIFICATIONS TO THE STAFF REPORT:

1. All references to the requirement for MPUC to submit the Approval to Construct from ADEQ be deleted;
2. All references to financing the \$1,500,000 cost of the sewer collection system in the recommendation should be deleted; and
3. MPUC be authorized to issue up to \$7,200,000 in equity instead of \$5,700,000 which will include the \$1,500,000 cost of the sewer collection system.